

September 15, 2006

MEMORANDUM TO: State Investment Council

FROM: William G. Clark s/*William G. Clark*<sub>(crb)</sub>  
Director

SUBJECT: **Proposed Private Equity Investments in Audax Mezzanine Fund II**

This due diligence memorandum is presented to the State Investment Council (the “Council”) pursuant to N.J.A.C. 17:16-69.12 (a) to report on one proposed private equity investment: a \$50 million commitment to Audax Mezzanine Fund II.

Please note that this investment will be authorized pursuant to Articles 69 and 90 of the Council’s regulations which became effective on June 20, 2005. The Audax Mezzanine Fund II investment will be considered a “Debt-related Investment” as defined under N.J.A.C. 17:16-90.2 (a).

The Alternative Investments Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (myself in an acting capacity) and the applicable Asset Class Consultant (Strategic Investment Solutions for private equity, or “SIS”) in coordination with the DOI Investment Committee (Ike Michaels and myself).

As a result of internal and external sourcing, the DOI Investment Committee identified the proposed investment. As a result, SIS and Division staff proceeded to undertake extensive due diligence on the proposed investment. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that the proposed investment meets the criteria for investments set forth in the Alternative Investment Procedures.

The investment we are proposing focuses on the Mezzanine debt market. The general partner for Audax Mezzanine Fund II will invest in a well diversified portfolio of mezzanine securities, with a specific focus on middle market companies. The general partner has a history of making successful mezzanine investments and has demonstrated the ability to generate top-quartile returns. Overall, the senior principals have 85 years of experience in finance, credit analysis, transaction structuring, due diligence and investing. A critical element of the Fund's investment strategy is to perform thorough credit analysis on all investment opportunities. Underlying this extensive credit analysis will be the preservation of invested capital. The general partner will be investing a significant amount in the Fund, ensuring that the limited partners' interests are aligned with those of the general partner. The management fees are reasonable, and all the legal and economic terms associated with the partnership are fair and consistent with market standards.

A formal written due diligence report for each of the proposed investments was sent to each member of the Investment Policy Committee of the Council on September 8, 2006, and a meeting of the Committee was held on September 13, 2006. In addition to the formal written due diligence reports, all other information obtained by the Division on this investment was made available to the Investment Policy Committee.

After review of the extensive due diligence, the Investment Policy Committee of the Council decided to report on the proposed investment to the full Council pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern each investment. In addition, each proposed investment must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with the other general partner.

We look forward to discussing the proposed private equity investment at the Council's September 21, 2006 meeting.

WGC:cae  
Attachments